Local exchange rates are regulated at the state level, and are frequently politically sensitive. They affect every subscriber in a direct and (superficially) easily understood way, and are easy to focus on politically. The availability of a regulatory process, and early successes in using that process, to keep local exchange rates low, has generated in American society the perception that low local exchange rates are, as Alfred Kahn noted, a "God-given right."[1] We tolerate with equanimity paying what it costs to produce necessities like food and clothing, but whenever the price of local telephone service is raised to more closely reflect its cost, moral outrage is generated. This populist force, justified or not, has been a powerful driver of telecommunications regulatory policies. Under monopoly, regulatory pricing in the telephone industry has been the product of political as well as economic processes. In other words, regulators often balance competing considerations of what something does cost with what political judgments say it should cost. As one observer has commented: "The sensitivity of consumers to telecommunications prices, the closeness of state regulators to the electoral process, coupled with the fact that most telecommunications customers are in the residential class means is [sic] that we should expect to find that regulatory authorities have been, and still are, extremely reluctant to raise local telecommunications prices."[2]

The other set of prices that has received heavy regulatory attention in recent years (since the MFJ took effect in 1984) is access charges, i.e., the charges levied by local exchange

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[1] Alfred E. Kahn, *The Road to More Intelligent Telephone Pricing*, Yale Journal on Regulation, Vol. 1: 139 (1984), p. 153.

[2] John T. Wenders, The Economics of Telecommunications, Cambridge, MA: Ballinger Publishing Company, 1987, page 155.

carriers on interexchange carriers to "pick up" and "deliver" long distance calls to and from end users. There is little doubt that these charges are above economic cost. Contrary to allegations sometimes leveled by interexchange carriers, however, access charge levels have little, and perhaps nothing, to do with ILEC inefficiency or monopoly profits. Rather, they are simply the latest consequence of policies designed to keep local exchange prices at politically tolerable levels. Thus, access charge levels that exceed economic costs are nothing new, and say nothing about whether or not ILECs are operating efficiently, or, for that matter, anticompetitively.

A. Social Policies, Subsidies, and Separations

There have been a number of policy trends over the years which make possible the politically-based pricing policy of keeping local rates lower than the cost of providing local exchange service. First, barriers to entry made it feasible for regulators to price without regard to cost. This began to change with the appearance (and regulatory approval) of microwave service providers, typified by MCI, in the late 1960s and early 1970s. Before that, AT&T and its regulators in each jurisdiction had great flexibility in deciding from which parts of the system to recover the overall costs of doing business. Thus, unlike other businesses, there was not necessarily a close link between the costs and prices of particular services. Only in the aggregate did revenues match costs.

Second, technological trends in the telephone industry has been very rapid, with the result that the overall real telephone price level has been reduced over time. Moreover, the most rapid technological change was in the area of long distance service. This provided regulators and AT&T a substantial degree of freedom in pricing all services. If retail telephone

prices were simply a product of input prices and productivity trends, as they are in most competitive markets, long distance service prices would have dropped more rapidly, reflecting the rapidly falling costs. On the other hand, local exchange service prices would have fallen much more slowly, or perhaps even risen slightly, had they simply tracked trends in underlying costs. Of course, this was not the pattern that actually occurred.

Third, and important to an understanding of the political process that took place, toll usage was fairly highly concentrated in a small fraction of the business and residential customers. Politically, every subscriber had an interest in local exchange service pricing, but only a smaller group of customers had the same concerns about the level of toll prices. Thus the stage was set for traditional (and still extant) telephone pricing practices. Today's local exchange and access charges are the legacy of yesterday's pricing decisions, and of so-called separations procedures.

A central fact of telephone service is that in order to use it, the customer must be connected to the network. That connection involves a real economic cost that is incurred regardless of whether or not the customer actually does use the network. Merely by being hooked up, the subscriber imposes an identifiable and measurable cost on society. Therefore, cost-causative pricing principles would require that each telephone subscriber pay whatever it costs to provide customers this network access.[3] The history of local and long distance telephone regulation is of a fifty-year effort to avoid this outcome.

[3] The network externality value for each user associated with maximizing telephone service penetration may call for a price somewhat below the cost, at least in theory.

Another feature of telecommunications networks is that a wide range of services make use of the same common facilities. The costs of these commonly used facilities, in particular local exchange facilities, have been apportioned by regulators and companies between jurisdictions, customer classes, and services, using arbitrary processes termed "separations" and cost allocations. Rather than directly assign these costs on the basis of cost causation, a complex regulatory accounting system is used.

Prior to the 1930's, the Bell System assigned costs on the basis of which side of the "toll board"[1] a facility or service lay. This meant that the cost of the local exchange network resided entirely in the state jurisdiction, a circumstance that did not please state regulators in spite of the fact that it was perfectly consistent with well understood principles of cost causation. Their protest led to the 1930 decision of Smith v. Illinois Bell in which the Supreme Court ruled that unless an apportionment of costs reflected the way a facility was used, "the intrastate service to which the exchange property is allocated will bear an undue burden." As a result of this conceptual error in economics by the Court, the interstate portion of costs previously delineated at the toll board (board to board), now had to include costs from the customer to the toll board and vice versa (station to station).

It was at this point that regulatory pricing principles in the telephone industry departed from the anchor of cost causation. Henceforth, local exchange price levels were to be political and judgmental matters, rather than an economic determination. As a result, to the extent a

[4] The toll board was the demarcation point between local exchange service and long distance service.

service's price was set below its directly attributable costs, revenues had to be obtained from other services or sources to make up the difference. Thus was born the complex system of cross-subsidies with which we still live today, designed to produce the revenues necessary to cover the telephone companies' overall costs.

The cost allocations involved in this process were not specifically identified as subsidies in the early period. Moreover, they were not recognized as such by telephone customers (with the exception of the few larger/and more sophisticated users) until competition began to appear much later -- and not even then in some cases. Rather, a subjective, but suitable Separations Manual was finally developed in 1947 to guide the allocations required by the Supreme Court. In the Separations Manual, broad allocators determined how costs would be assigned and drove pricing policies that rested on "separated" costs, rather than economic costs. The allocators chosen, while sometimes having a superficial plausibility, were (and are) completely arbitrary from an economic point of view, a fact that is increasingly confronted as competition (when allowed to function freely) drives prices toward costs. The central problem with this process, in Wender's words, is that "costs can be discovered, costs can be identified, costs can be estimated: But costs cannot be allocated. They are not a pie to be divided up among customers."[1] However, while highly inappropriate from an economic efficiency point of view, separations proved to be a politically convenient policy tool and was of course quite sustainable in a monopoly environment.

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[5] John T. Wenders, The Economics of Telecommunications, Cambridge, MA: Ballinger Publishing Company, 1987, page 59.

Regulators were not long in taking advantage of the opportunities provided by the inherently manipulable separations process. From the 1940s to the 1970s the proportion of local exchange costs assigned to the interstate jurisdiction rose steadily, as a result of both regulatory and political pressures. Early on, the FCC made a questionable determination that certain capital costs be associated with the completion of interstate calls to the long distance portion of AT&T.[6] However, the move appeared plausible and was politically acceptable because it helped to reduce AT&T's nominal over-earnings in the long distance portion of regulated accounts, while at the same time allowing local rates to decline. Implicitly, separations procedures provided a basis for the evolving notion of universal service, which essentially came to be equated with below-cost local exchange rates.

Expenses that did not vary with usage, termed "non-traffic sensitive" (NTS), particularly those associated with the local loop (subscriber access), were apportioned on the basis of subscriber line use (SLU), measured as relative minutes. A series of cost allocation plans (Charleston, Denver, Phoenix and the Ozark plan) modified the details, and over time expanded the implicit subsidy from long distance to local service. The final (Ozark) plan assigned about 3.3% of NTS costs to the federal jurisdiction for every 1% of interstate calling. This "multiplier," known as the subscriber plant factor (SPF), had only the thinnest of rationales and, once again, had nothing at all to do with cost causation. It is important

[6] Carol L. Weinhaus and Anthony G. Oettinger, Behind the Telephone Debates, Ablex Publishing Corp. (1988), pp. 62-63.

throughout these discussions to recognize that these allocators, while superficially plausible (and highly salable), have nothing to do with underlying costs. They are entirely arbitrary.

Over the period from 1943 to 1980, the percentage of local loop plant assigned to the interstate jurisdiction nationally rose from zero to about 28%, later was rolled back to 25% and then was frozen at that level The overall effect of the allocations process prior to the onset of competition appears at first blush to be relatively benign. In fact, it has caused more regulatory problems, as competition began to unfold in the industry, than any other single factor. The various cost allocation plans shifted more and more of the costs and investment incurred to develop the intrastate portion of the network to the interstate portion, thereby allowing basic local exchange service to be priced lower than it would have been had it been required to stand on its own feet. In addition, a portion of the local loop costs that remained in the state jurisdiction after separations have been recovered in rates for intrastate toll and vertical services, also for the purpose of keeping local exchange rates low. Separations and intrastate subsidies may to some degree have resulted in a further expansion of the public switched network, although rising real incomes and increased societal mobility may have been even more important forces. In any event, household telephone penetration rose sharply in this period of time.

The rapid rate of technological change occurring in the long distance segment of the industry generated enough new efficiencies to hold down local rates and still generate some reduction in long distance charges. Increasing the subsidy to local service just meant that prices in long distance did not fall as rapidly as they otherwise might have, and they did not have to be

raised. This met a critical political need: no rate increase for any service had to be explained by regulators or politicians. The "tax" that was being imposed was simply unobserved by most people. AT&T was the main recipient, as well as the payer, of the subsidy, and so was more comfortable with the process than perhaps it might otherwise have been; at least so long as its markets were not open to competition. Finally, the politically important independent (i.e., non-Bell) telephone industry, heavily rural in nature, also benefited, thus adding another level of support to the policy of subsidizing local rates.

Not all of the consequences were so benign, however. The policy of overpricing toll service at both the federal and state levels seriously repressed usage, resulting in significant welfare losses to toll users, would be toll users, and the economy as a whole. Subsidy policies that inflate long distance rates also, at first subtly, but later more and more powerfully, created strong economic incentives for other companies to enter the long distance market. The development of microwave technology, ironically enough by AT&T's own Bell Labs, was to provide the opening for competitors to act on these incentives. Thus the subsidy policy had sown the seeds of its own destruction

B. The Coming of Competition

Taxing long distance service through arbitrary (from an economic point of view) cost allocations was inefficient, but it initially presented few practical problems from a regulatory perspective. The onset of competition as a result of the FCC's Execunet decision, and its expansion in the late 1970s and early 1980s, turned this situation on its head.

While MCI provided, either by buying or leasing facilities, its own interexchange network, it anticipated connecting its facilities to the local Bell central office by an ordinary business telephone line, at the usual tariffed rates. At this point AT&T objected. Because the SPF-multiplied separations factors used in the jurisdictional cost allocations were based on the interstate/intrastate minutes of use ratio, AT&T's long distance service effectively was paying a substantially higher rate for its own connection to the central office than was reflected in an ordinary business line charge. AT&T's long distance service was, in effect, paying a tax to support low local exchange prices. A long distance competitor allowed to use ordinary business service for central office access would not have to pay the tax. Worse still, the long distance competitor might get the benefit of the tax that AT&T was paying in the form of network access via an underpriced business line.

The initial AT&T response was to file in 1978 the Exchange Network Facilities for Interstate Access (ENFIA) tariff for the "new" service of interexchange access. The ENFIA tariff replicated the implicit charges it estimated that its long distance service was "paying" through the separations allocation procedures. Although "interexchange access" was distinguished from other local exchange access for regulatory purposes, it was functionally identical to services sold to other (non-interexchange) business customers. Thus, switched and special (dedicated private line) access tariffs reflect a legal, not a technical, distinction. By approving the ENFIA tariff, the FCC implicitly acknowledged the legitimacy of interconnection as a separate "service," carrying with it special responsibilities to contribute to the maintenance of social goals and policies.

Looked at differently, the ENFIA tariff recognized the illegitimacy, and ultimate futility, of taxing only one company's services among a group of close substitutes. The dangers of allowing new entrants simply to arbitrage regulated prices was recognized early on. In fact, although not so termed when it was initiated, ENFIA provides an early application in telecommunications of the principle of competitive parity, as well as the use of imputation. Competitive parity requires that each participant in a market contribute to the recovery of government-imposed social policy obligations. ENFIA charges for interconnection, paid by MCI and other long distance competitors, had the effect of placing those firms in regulatory circumstances similar to where AT&T found itself as a result of years of separations allocations to the interstate jurisdiction. This is the competitive parity principle being applied. As we have already seen, these separations procedures had nothing to do with the cost of providing local exchange access, so ENFIA required competing companies to pay roughly the same tax that AT&T's long distance service was paying. Second, it was possible to estimate, that is impute, that portion of AT&T's long distance retail prices that reflected the implicit subsidy of local exchange access. While ENFIA charges were not set at 100 percent of the imputed amount, primarily for technical quality reasons, the imputed values were the starting point in the development of competitive parity.

The ENFIA tariff has provided the basic analytic structure for the assignment of revenue responsibilities in situations where regulatorily authorized or encouraged cross-subsidies are involved, down to, and including, today's interconnection pricing and access reform discussions.

Following the divestiture of AT&T's local operations into Regional Bell Operating Companies (RBOCs), subsidy payments were no longer "all in the family," and the separations, settlements, and division of revenues approaches to the cross-subsidization of local exchange service became impractical. Therefore, a new switched access charge system (Part 69) was designed by the FCC to modify the procedures and many cost allocation plans that had evolved during the years from 1940 to 1970 under the auspices of the FCC and the state commissions (through a Joint Board of FCC and state utility commissioners).

While the new switched access charge arrangements contained many new technical details and applied to all interexchange carriers (AT&T included), they represented continuity with the old system, not a departure. Indeed, as the switched access discounts to new entrants, which were provided in the ENFIA tariff, have been phased out, the new system approaches still more closely the principle of competitive parity among IXCs. That is, the thumb that was previously on the interexchange competition scale weighing down AT&T finally was removed. The new access charges are, from an economic perspective, simply a tax on access over and above what it actually costs to provide the service. All interexchange companies pay it, so that at this level, at least, competition can occur on a fair basis.

To summarize, the subsidization policies that the post-divestiture access arrangements pursue are simply old -- albeit important -- wine in new bottles. From this necessarily lengthy historical perspective, today's access reform proceeding can be seen as an attempt to remove excessive taxes paid by IXCs, while at the same time maintaining appropriate revenue flows to ILECs.

C. The Telecommunications Act of 1996 and Access Charges

The Telecommunications Act of 1996 envisions additional major changes in the organization and regulation of the industry. First, the Act embraces local exchange competition as a national policy goal, and advances a number of policies, particularly in the areas of local exchange interconnection, to support it. If these policies are designed correctly, the last redoubt of monopoly should disappear in favor of a truly competitive industry at all levels. Second, the Act recognizes the desirability of replacing the existing implicit universal service and cost recovery structures with an explicit, competitively neutral, and hopefully less distortionary, support mechanism. A third major policy change, which the FCC has called part of its "competition trilogy" (along with interconnection and universal service), is access charge reform. All three sets of policy initiatives reach for important and desirable public policy goals.

Critical features of the historic regulatory environment described above must be remembered and accounted for as universal service and access charge reform initiatives are implemented. Particularly important is a recognition that today's access charge levels relative to incremental cost do not represent ILEC inefficiency or monopoly rent; rather, they are part of the end result of an explicit public policy commitment to keep local service rates lower than they otherwise would be. An appreciation for the history of access charges helps to correctly judge the merit of allegations that access charge levels are the result of anticompetitive motives on the part of the ILECs.

III. RATE STRUCTURE CHANGES

Economic pricing principles suggest that the price for a service should reflect the way costs are incurred to provide the service. For example, costs that do not vary with usage should be charged on a flat basis, so that the variable costs that drive customers' choices at the margin can be a fair reflection of true economic costs. Prices also should differ based on geography to the extent that costs differ geographically. In terms of telecommunications, Alfred Kahn described this requirement for economically-efficient pricing as follows:

> Assuming metering costs are not prohibitive, an efficient telecommunications pricing system would therefore charge each user a two-part tariff. One part would be a fixed access charge (levied either as a lump-sum or on a periodic basis), which would cover only the marginal non-traffic-sensitive costs of connecting the customer with the existing system. Such a charge would vary substantially among customers depending on their locations and on other factors that may cause those costs to differ. The second part of the tariff, related to traffic-sensitive costs, would vary with the customer's usage of the network and would reflect the mix and duration of intra- and interexchange calls and the times the calls were made.[7]

Inefficient carrier access charges have suppressed demand for interstate services and have increased the likelihood of uneconomic entry. Developing an efficient rate structure is desirable in and of itself in order to send the correct pricing signals to suppliers and customers, but it becomes a necessity as competition for access increases. The Commission has correctly concluded that Part 69 compels incumbent local exchange carriers (ILECs) to impose

[7] Alfred E. Kahn, *The Road to More Intelligent Telephone Pricing*, Yale Journal on Regulation, Vol. 1: 139 (1984), p. 141.

inefficient charges for access services, and that "establishing more economically rational rate structure rules is a necessary first step in the new procompetitive era."[8] Specifically, the Commission noted that it requires ILECs to recover a portion of NTS loop and switching costs through usage charges, and it stated that it seeks to send more accurate pricing signals.[9]

An economically rational approach would be to allow ILECs to recover NTS costs through increases in the Subscriber Line Charge (SLC) for end-users. However, a consensus apparently is developing in favor of the Universal Service Joint Board recommendation not to increase the SLC, at least in terms of the residential service "first-line." If this policy is adopted, some other fixed charge levied on IXCs must be developed to recover the fixed costs that are currently in usage charges. Options for such a charge include a fixed charge per presubscribed line, called a PIC (presubscribed interexchange carrier) charge, "bulk-billing," in which carriers are assessed a charge based upon their share of total interstate usage, or some form of capacity charge assessed on trunks. However this is accomplished, the FCC must take care to ensure that a flat-rate recovery scheme does not implicitly become based on access usage, thus undermining the goal of changing the rate structure.

The PIC charge has the advantage of having lower transactions costs than the other options listed above, but it does create some avoidance incentives that would have to be addressed. IXCs most likely would pass through the PIC charge to end users, so it may give

[8] FCC Notice, ¶¶ 55-56.

[9] Id.

customers an incentive to not presubscribe with any interexchange carrier and use access codes for all interexchange calling. Therefore, it would be appropriate to directly assess the PIC charge to end users who refuse to presubscribe their long distance service.

Even if SLCs are not increased overall as a result of the Joint Board Recommendation, the Commission should permit ILECs to geographically deaverage them, including residential SLCs. SLC geographic deaveraging is consistent with cost-causation principles since loop costs vary with population density and geographic characteristics and thus prices that recover loop costs, such as the SLC, should reflect such variances. Local loop rates are in most cases being deaveraged by the states in interconnection arbitrations setting rates for unbundled network elements, so failure to deaverage SLCs would create a new set of uneconomic arbitrage opportunities for access competitors. By maintaining averaged SLCs, loop costs will be overrecovered in lower cost urban areas and underrecovered in higher cost rural areas. This creates the twin problems of providing uneconomic incentives for investment in cities, and inefficient restriction of consumer choice in smaller cities and towns.

IV. MARKET-BASED APPROACH VS. PRESCRIPTIVE APPROACH

In its access reform notice, the Commission seeks comment on whether it should rely on marketplace forces to transition access rates to efficient levels, or whether a prescriptive approach is necessary for the development of efficient competition.[10] I conclude that given the

[10] Id., ¶ 222.

progress of competitive forces in the local exchange, along with the regulatory requirements that have been established at both the national and state levels, a market-based approach is more appropriate.

Regardless of whether the Commission chooses to rely on marketplace forces or to prescribe the pace and the outcome for efficient access prices, the Commission should recognize the legitimacy of the ILECs' prudently-incurred costs and allow recovery of such costs in a competitively neutral manner. As I have stated in the context of restructuring the electric power industry:

> In my opinion, public policies aimed at introducing competition into electricity markets will proceed more quickly and effectively if the regulatory bargain is kept, and utilities are able to rely on regulators' previous financial commitments. Because regulation will continue to play an important role in some parts of the industry even as competition unfolds in others, policy makers interested in the efficient functioning of electricity markets must hold themselves to high standards of accountability for their own actions. Therefore, any plan to introduce competition in electricity must honor existing commitments and include a method for ensuring that shareholders are fully compensated for their past prudently-incurred investments.[11]

The same logic applies whether we are discussing the electric power or the telecommunications industry. Recovery of prudently-incurred costs is the crux of the regulatory bargain.[12] Failure of the regulators to abide by that bargain represents regulatory opportunism.

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[11] Direct Testimony of Kenneth Gordon, on behalf of Entergy Gulf States, Inc., before the Texas Public Utilities Commission, November 27, 1996, pp. 11-12.

[12] Alfred Kahn has suggested the use of another term for those who are uncomfortable with referring to the regulatory bargain: "If, for whatever reason of politics, law, or aesthetics, one objects to characterizing the implicit basis of these intensely contested [rate case] determinations as compacts or bargains, then, by good (continued...)

A. Market-based Approach

For the reasons laid out below, I urge the Commission to let the market operate to bring prices to efficient levels, as Congress intended it to do. Increasing pressure for access rates to become more efficient has been felt for some time. Several forces are responsible for this pressure: (1) the efficiency-generating incentives of the FCC's price cap plan for regulating access rates; (2) the emergence of competitive access providers in the latter half of the 1980's and their general evolution into competitive local exchange carriers (CLECs); and (3) technological changes, such as fiber-optics, that make it easier for access alternatives to develop on a larger scale. Coupled with the Act and the FCC's Interconnection Order,[13] particularly provisions allowing CLECs to use unbundled network elements priced at forward-looking costs as an alternative to traditional access, these forces will accelerate the transition and introduce exchange access alternatives to all geographic areas. All of these developments represent the market forces which should be relied upon to achieve efficient access prices. In fact, driving rates to efficient levels is one of the primary benefits and purposes of the competitive process.

(...continued)

fortune, we have a historical precedent for an alternative appellation -- let us call it a banana." Alfred E. Kahn, "Thirteen Steps to Reconciliation," Regulation, 1996 Number 4, pp. 14-16.

[13] Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996) (Interconnection Order), Order on Reconsideration, CC Docket No. 96-98, 11 FCC Rcd 13402 (1996) (Interconnection Reconsideration Order), *Petition for Review Pending and Partial Stay Granted, sub nom.* Iowa Utilities Board et. al v. FCC, No. 96-3321 and consolidated cases (8th Cir., Oct. 15, 1996), *Partial Stay Lifted in Part*, Iowa Utilities Board et. al v. FCC, No. 96-3321 and consolidated cases (8th Cir. Nov. 1, 1996).

The Act provides the substantive standards and process for introducing competition in the local exchange. Under the FCC's interpretation of the Act in its Interconnection Order, not only is the ILEC required to interconnect with competing networks, unbundled network elements may be combined to provide an alternative to the incumbent's access services.[14] This means that a prospective access competitor does not have to own any of the necessary elements to provide access service, such as loops, switches, transport, and operations support systems; rather, the entrant can purchase these elements from the incumbent to provide competitive access.[15] This competition is also protected by the Act's many competitive safeguards and antidiscrimination rules, coupled with existing state and federal regulations.

B. Prescriptive Approach

On the other hand, a prescriptive approach under which the Commission would speculate on what the efficient access price is, and mandate specific price changes to achieve it, would represent a step back from the market-based incentives of price caps and the Commission's commitment to the introduction of competition on economically efficient terms.

The Congress, the FCC, and the industry have gone through an extensive and time-consuming process to set the stage for competition in local exchange and exchange access

[14] Under the Commission's Interconnection Order, an IXC cannot use unbundled loops to offer interexchange access or service exclusively if the customer also requests local exchange service. This requirement should not be considered a barrier to access competition because the purchase of the loop by the IXC would make provision of local exchange service by that IXC relatively easy as a practical matter. See Interconnection Order, ¶ 357.

[15] Whether or not the FCC's mandate for "rebundling" is vacated or upheld by the appellate court, the availability of unbundled elements from the LECs, in combination with the CLECs' infrastructure ensures that entry and exit barriers are low.

services. A number of states now have actual competition and indeed had incipient competition prior to passage of the Act (Illinois, Michigan, Massachusetts, New York). Now is the time to see how the competitive process works. Otherwise, much of the effort expended in 1996 and earlier to establish open markets may have been for naught. If access rates are too high even after the Commission makes the proper rate structure adjustments, the associated price-cost margins will provide incentives for entrepreneurs and capital markets to create viable enterprises capable of competing with the incumbents. This window of opportunity may be closed if the FCC adopts the prescriptive approach to access reform. Should the market-based approach to access reform fail to achieve its goals, additional work on creating market conditions for competition may be required. Or failing that, a prescriptive approach could be used as a last resort. But the system needs to be tested at this point, not undermined.

The prescriptive approach also is not consistent with the principles of price cap regulation. Price caps rely on indexes representing expected cost changes, which provides incentives for the regulated company to be more efficient than the index presumes, while the prescriptive approach requires setting rates based on an administrative determination of prudent costs. I believe that the Commission's existing price cap has been successful and it has resulted in lower interstate access rates since its inception. The Commission should not now weaken the price cap incentive structure that has worked well, by backsliding into the world of adjudicating reported or estimated costs. The difficulty that the Universal Service Joint Board has had in finding an acceptable proxy cost model, after much discussion, comment, and analysis, should

serve as a reminder for the Commission of what it has apppropriately left behind in the movement to price cap regulation.[16]

Also, as the Commission itself noted, a prescriptive approach would require it to play a greater role in the telecommunications marketplace, rather than simply ensuring an appropriate framework for that market.[17] Specifically, such participation would require accurate forecasts of long-run efficient prices, a process that carries with it significant costs and risks of error, and a process that supersedes the central purpose of competitive markets. Prescribing the competitive outcome just as competition is developing is not harmless, for it forces prices to the prescribed level, whether or not that level represents an accurate prediction of the efficient market price.

1. The Prescriptive Approach Is Not Necessary for Efficient Competition

Interexchange carriers are likely to argue that in order to move to an effectively competitive world in long distance, presumptively efficient access charges should be prescribed on a flash-cut basis, and that those rates should be based on incremental costs, either total-service, long-run incremental cost (TSLRIC) or total-element, long-run incremental cost (TELRIC). In reality, the Commission would be relying on speculation. Moreover, the IXCs' arguments in terms of competition are likely to be both incorrect and a self serving attempt to

[16] "We cannot recommend that any of the proxy models submitted in this proceeding thus far ... should be used to determine universal service support levels. While the proxy models continue to evolve and improve, none of those submitted in this proceeding are sufficiently developed to allow us to recommend a specific model at this time." FCC 96J-3, In the Matter of Federal State Joint Board on Universal Service, CC Docket No. 96-45, Recommended Decision, released November 8, 1996, ¶ 268.

[17] FCC Notice, ¶ 218.

handicap competitors by using administrative process. They argue first that removing contribution from the access price, and thus setting the price at TSLRIC or TELRIC, is necessary to enhance competition, and second, that they cannot compete with the ILECs (after they are allowed into the long distance business) if the latter are allowed to receive access revenues in excess of the incremental cost of providing access, as that will somehow constitute a price squeeze. Neither claim withstands scrutiny.

We have already been through an extensive proceeding in CC Docket No. 96-98, in which the merits and methodologies of cost-based pricing have been debated. The Commission correctly concluded in that docket that pricing at TSLRIC or TELRIC will not allow the ILEC to recover its joint and common costs, prescribing instead a reasonable allocation of joint and common costs in the prices for network elements and interconnection. While the ultimate outcome of that docket is still unknown given judicial challenges, it is clear from the Interconnection Order and the reasoning behind the Eighth Circuit Court's Stay that pricing to recover only TELRIC costs is unreasonable. The pricing of access services is no exception to this rule.

Where there must be burdens, either for historical or forward-looking reasons, the essence of a level competitive playing field is that all players are subject to the same external burdens and, thereby, are allowed to succeed or fail on the basis of their relative efficiencies in providing the competitive service. As long as all IXCs pay the same access charge, competition among them is not impaired, even if that access charge includes a markup for joint and common or universal service costs. When Bell Operating Companies (BOCs) are allowed

to enter the long distance market, the same will be true as long as two requirements for competitive parity are met: first, that the BOCs do not offer themselves better terms of access, either overtly or implicitly; and second, that the BOCs do not cross-subsidize their competitive services using revenues from their less competitive or monopoly services.

The Commission referenced the cross-subsidy issue by noting that several parties (primarily the incumbent IXCs) have argued that, as long as ILEC switched access service is priced above incremental cost, there is a non-traditional price squeeze that ILECs can apply to unaffiliated competitors in the interLATA market.[18] According to this theory, a Bell Operating Company within its region will attempt to stimulate overall interexchange usage, and thus additional access revenues for itself, by having its interLATA affiliate price its service lower than it would if it was a non-integrated, profit-maximizing participant in the interLATA market. In this way, the ILEC maximizes corporate earnings by stimulating more access revenues than it foregoes due to the lower prices in the interLATA market. The IXCs argue that access rates therefore should be prescriptively lowered to TSLRIC or TELRIC in order to eliminate this incentive for the ILECs as they enter the interLATA market.

The incentive for integrated ILECs to lower their prices more than they otherwise would is one of the benefits of ILEC entry to interLATA services.[19] The Act, and the FCC's

[18] FCC Notice, ¶ 47.

[19] Paul W. MacAvoy, The Failure of Antitrust and Regulation to Establish Competition in Long-Distance Telephone Services (The MIT Press and The AEI Press) 1996, p. 179. David S. Sibley and Dennis L. Weisman, "The Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," April 1996 (Revised December 1996).

interLATA safeguards order implementing it, contain sufficient constraints to prevent ILECs from subsidizing their interLATA services. Price reductions that do not result in a cross-subsidy are a large part of the benefits intended by Congress in allowing additional competitors into the interLATA market. The Commission notes that ILECs operating on this incentive may cause incumbent IXCs to "match the price reduction and absorb profit margin reductions or maintain their prices at existing levels and accept reductions in their market shares."[20] That is what is supposed to happen to the benefit of customers when a somewhat closed market is open to further entry.

The argument has also been raised, however, that even when ILECs do not price interLATA service below cost, the price reductions are still harmful because they could cause underrecovery of the IXCs' fixed costs (see Franklin M. Fisher, "An Analysis of Switched Access Pricing and the Telecommunications Act of 1996," page 10). This argument assumes a measurement of incremental costs that is not consistent with the incremental cost standards currently being used by the FCC and most states, and most prominently advocated by AT&T and MCI, to measure subsidization. The incremental cost standard that is being used most commonly today to measure subsidies is TSLRIC or TELRIC (described earlier). Properly calculated, both TSLRIC and TELRIC should include all of the going-forward costs, both fixed and usage-sensitive, that a firm incurs in providing a service or network element, and which it

[20] FCC Notice, ¶ 47.

would not incur if it did not provide the service or network element.[21] Therefore, as long as the ILEC does not violate the cross-subsidy prohibition and the IXCs' long-run incremental costs are lower than or equal to the ILEC's, IXCs will recover their fixed costs. If the IXCs long-run incremental costs are higher than the ILEC's, economic efficiency requires that IXCs not recover those costs. As noted earlier, TSLRIC and TELRIC do not provide for recovery of joint and common costs, but the method for recovery of joint and common costs is not relevant to the calculation of a subsidy.

The price squeeze in theory could also be implemented by raising rivals' costs through subtle, covert discrimination. There are several reasons to suggest that such discrimination will not be undertaken, or, if it is, that it would not be effective. First, there is no evidence to suggest that Ameritech has ever engaged in an effective discrimination strategy in other markets in which it both supplies an essential input and competes to supply the final product.[22] Such services include intraLATA toll, information services, intraLATA 800 and WATS services, and cellular. Second, requirements of the Act, and in current state and federal regulations, prohibit such discrimination and also provide safeguards to discourage it. These safeguards include the separate subsidiary, equal access, tracking and monitoring, and various

[21] The Commission stated in its interconnection order that "[t]he term 'long run,' in the context of 'long run incremental cost,' refers to a period long enough so that all of a firm's costs become variable or avoidable." FCC 96-325, First Report and Order, CC Docket Nos. 96-98 and 95-185, released August 8, 1996, ¶ 677.

[22] In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Michigan, Joint Affidavit of Richard J. Gilbert and John C. Panzar on Behalf of Ameritech Michigan, January 2, 1997, pp. 28-32.

other requirements. Third, competitive access services are rapidly developing and represent perhaps the most stringent prophylactic to discrimination.

While the alleged price squeeze is a theoretical possibility, the incentive for the ILEC to execute it holds under narrow market conditions that are unlikely to occur. The ILEC's interLATA market share must be high enough for the ILEC to influence the market price in order to stimulate overall demand and generate access revenues, but, the greater its market share, the more revenue it will be foregoing in the interLATA market. At some point, if its market share continues to grow, the additional access revenues that it stimulates will not be sufficient to pay for the foregone interLATA revenues. It is unlikely that the ILECs will be able to manipulate the market to the point where they keep their interLATA market share within the narrow band that makes this incentive profitable.

V. APPROPRIATE TRIGGERS AND PHASES FOR REDUCING REGULATION

The Commission has suggested that in conjunction with reliance on marketplace forces for the transition of access rates to economically-efficient levels, it would reduce regulation of incumbent LECs in phases, with the boundary between each phase identified by certain clearly identifiable "triggers." This proposal represents a recognition by the Commission that there is a certain gray area between a monopoly and the development of competition sufficient to allow complete deregulation. As competition is introduced, it is appropriate for the Commission to reduce regulation with one primary goal in mind -- ensuring that as customers are increasingly able to exercise choice, entrants and incumbents each are not constrained by regulation from